

# Under The Microscope: Thermo Fisher Scientific

Formed in 2006 through the merger of Thermo Electron and Fisher Scientific, the company is a world leader in providing analytical laboratory equipment and consumables used in the discovery, analysis, and manufacturing of pharmaceutical and other life sciences products.

*Over the past 18 months, Thermo Fisher Scientific (Thermo) has experienced a surge in demand for its suite of vaccine discovery, analysis and testing products to help combat the COVID-19 pandemic. While the market took the view that much of this demand was transitory, our analysis suggested that the pandemic had significantly expanded Thermo's opportunity set.*

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## A Reputation for Reliability

Thermo's business operations possess a unique trait that we can best describe as offering a high 'value-to-cost' ratio to its customers. In short, this refers to providing a product that is highly valued by the customer (and enables them to perform their daily tasks accurately and effectively) while only constituting a relatively small component of the total cost of carrying out said tasks. This attribute is best illustrated by way of a brief example:

The potential cost to a laboratory technician of using faulty or malfunctioning equipment when formulating and testing new compounds to be used in any drug can be disastrous – both to the pharmaceutical company engaged in drug development as well as the ultimate patient who consumes the drug. Faulty lab equipment can not only lead to inaccurate measurements (which waste time and resources) but can create significant reputational risk and incur severe regulatory sanctions.

Thermo's reputation for developing and providing best-in-class, technologically advanced equipment that is both accurate and reliable confers a strong element of pricing power for the group. The lab technician in our example knows that with Thermo they are getting a far higher quality product for a moderately higher price that will ultimately lead to cost savings from higher operational uptime and measurement accuracy, while at the same time mitigating downside risk.

## A One-Stop Shop

Providing thousands of business-critical products in markets around the world, Thermo operates across a broad spectrum of industries with numerous competitors in each. Over decades, Thermo has built up a subtle but important advantage in offering one of the broadest product baskets in the market. Having the ability to provide their clients with one invoice for all the equipment and consumables required to run their business allows researchers and scientists to spend more of their time in the laboratory and less time on ancillary matters such as procurement. As a result, customers tend to consolidate their spending with Thermo over time. Ultimately, the wide product range creates a scale advantage that allows Thermo to be more cost competitive across its customer base, while still having a clear ability to pass on inflationary cost increases in any one particular item to that customer.

## Creating Value for Shareholders

As a rule, we seek to invest in businesses that are highly cash generative; Thermo exhibits this core quality in spades. We then take our analysis a step further to identify businesses that are run by skilled management teams who can redeploy this capital into adjacent markets and products that deepen the competitive positioning of the business through time. Done repeatedly, astute capital allocation enhances investor returns over long periods of time, and can even 'bootstrap' value-creating transactions in tough market conditions.

Thermo's management team have a strong track record of acquiring businesses selling products that are complementary to the existing product basket and highly valued by their customers. The scale advantage that Thermo brings to any acquisition means that unlike other acquirers, they do not need to buy a business growing at a faster rate than the broader group. Instead, Thermo has a proven ability to accelerate the revenue growth of an acquired business through an expanded sales and distribution reach, while at the same time growing the operating margins sustainably of the overall group.

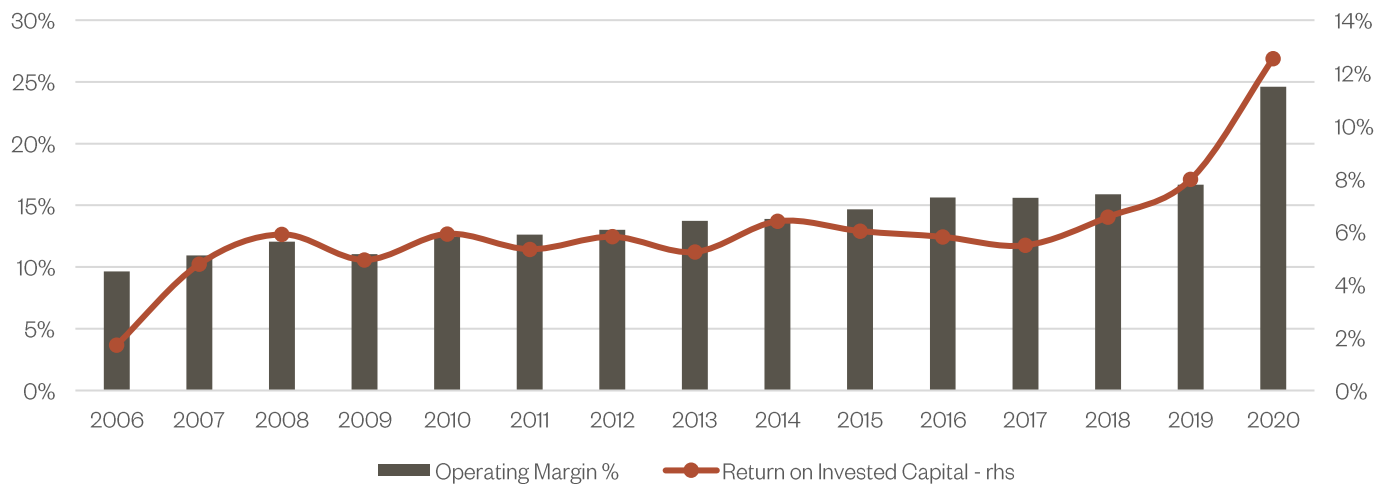
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Simplistically, the growth rate of the acquired business is less relevant than the quality of the product at the time of being acquired.

Thermo’s current management team have over 20 years of experience in focusing the group’s capital investment on capturing the lower risk parts of the value chain. Two recent acquisitions leverage Thermo’s scale advantage by acquiring both a clinical research organisation (PPD Inc. – a competitor to former Fund holding ICON Plc) to undertake clinical drug trials on behalf of customers, as well as a pharmaceutical contract manufacturer.

This vertical integration strategy means other participants will take on the regulatory risks of new drug approvals required to bring drugs to market, while Thermo partners with these companies to capture value from the clinical trial stage all the way through to packaging and labelling of the eventual product.

### Expanding Margins & Returns



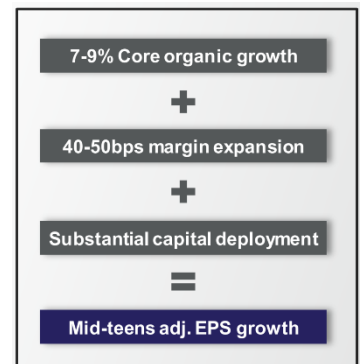
Source: Company data, FactSet

### Sustainably Higher Levels of Demand

As mentioned previously, Thermo benefited from providing products that experienced a surge of demand in 2020 to help combat the COVID-19 pandemic. Following the announcement of effective vaccines in November 2020, the stock retreated as short-term traders viewed the revenue generated in response to COVID-19 as transitory and unlikely to recur. Ignoring the fact that we believe global biosecurity efforts will be permanently higher as a result of COVID-19 – leading to some level of sustained demand for testing products – our analysis suggested that the underlying technological innovation of the way in which viruses are studied and vaccines developed would drive a permanent change in demand for the products that Thermo sells. The rapid timeframe for the effective discovery, approval and manufacture of COVID-19 vaccines globally were years in the making, enabled by businesses such as Thermo.

Given our view on sustainably higher levels of demand – and our confidence in a management team that wisely allocates capital and consistently reinvests in expanding the capability and capacity of the group to service aforementioned demand – our investment thesis essentially took advantage of the market’s short investment horizon (“now that we have vaccines, what should I own to benefit from the economic rebound?”) to purchase part of a deep-moated business with a long runway of growth at what we considered to be a perfectly attractive price.

At their September 2021 investor day, Thermo Fisher’s management confirmed that revenue growth from 2022 onwards would indeed be at a faster rate than what was experienced by the business prior to the 2020 pandemic, largely as a result of the factors we had outlined above. In addition, ongoing margin expansion and disciplined capital allocation – using twin levers of acquisitions and share repurchases – would see earnings



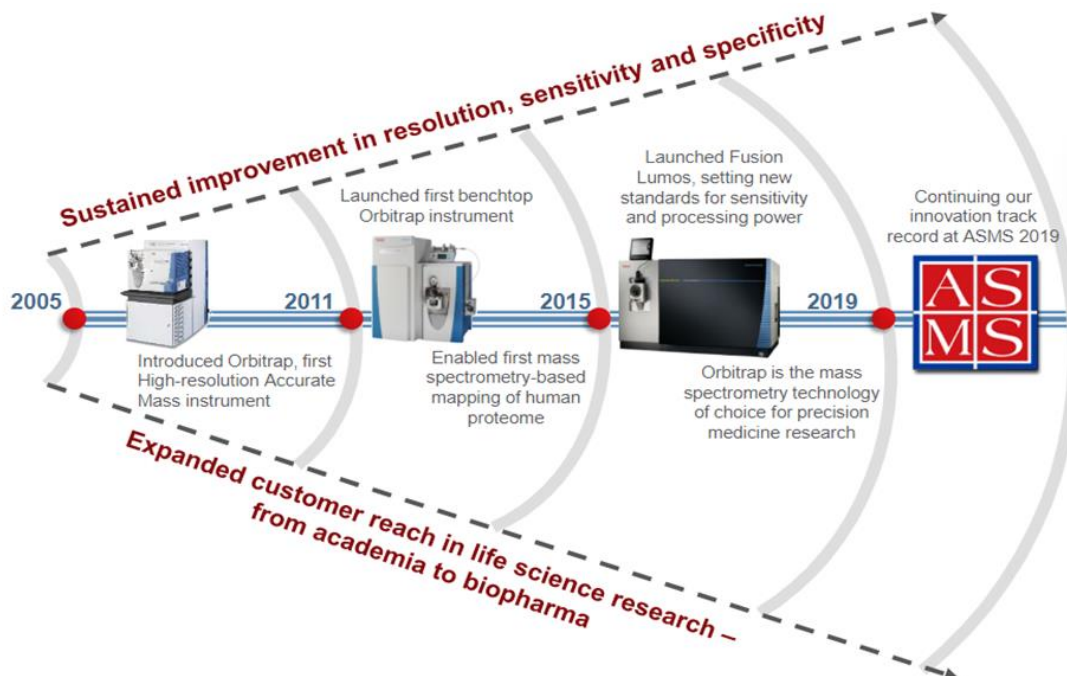
Source: Thermo Fisher Scientific Investor Day 2021

and free cash flow compound at mid-teens rates of growth. Following the investor day, we have increased our allocation to Thermo as the risk/reward equation has developed favourably for our investment thesis.

### Complexity Compounds the Long-Term Opportunity

The world around us gets more complex every day. To use a simple example: if one thinks about the groceries that we buy on a daily basis, the displayed nutritional information of the ingredients continuously becomes more numerous and detailed in nature as consumers become more educated and regulators stricter about disclosing the content of the food we consume.

As the world becomes more complex, the trend towards more data requiring more analysis will play out in numerous ways. What may appear to be a relatively pedestrian pace of advancement on a day-to-day basis can create enormous opportunities when taking a longer-term perspective. This fact allows us to take advantage of trends that may be of little to no relevance to short-term traders. Technological innovation allows for what historically may have been expensive, time-consuming analysis and diagnosis to become more affordable and more accurate in shorter time periods. By way of example, the Orbitrap mass spectrometer that Thermo manufacturers today is a much more powerful and advanced piece of equipment than when it was first introduced in 2005.



Source: Thermo Fisher Scientific

This never-ending technological advance broadens the use cases and customer base for Thermo, who continually reinvest in the research and development of new innovations that simplify the measurement of an increasingly complex world. If the truism that "if something is to be managed, it is to be measured" is accurate, then owning a business that sells the measurement equipment makes sense to us.

Thermo Fisher Scientific fits our criteria of being run by a management team that understands the benefits of combining market leading organic growth with prudent capital reinvestment at attractive rates of return. In combination, these two factors drive the long-term compounding of shareholder value.